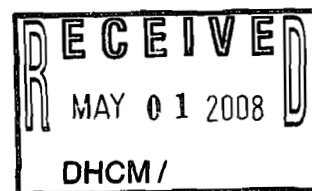


# SCAN Long Term Care

Financial Statements as of and for the  
Year Ended December 31, 2007, and  
Independent Auditors' Report





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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors of  
SCAN Long Term Care:

We have audited the accompanying statement of financial position of SCAN Long Term Care (the "Company") as of December 31, 2007, and the related statements of activities and changes in net assets and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2007, and the results of its operations, changes in net assets, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Deloitte + Touche LLP*

April 18, 2008

## SCAN LONG TERM CARE

### STATEMENT OF FINANCIAL POSITION AS OF DECEMBER 31, 2007

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#### ASSETS

##### CURRENT ASSETS:

|                                           |               |
|-------------------------------------------|---------------|
| Cash and cash equivalents                 | \$ 16,373,680 |
| Premiums and other receivables — net      | 873,997       |
| Prepaid expenses and other current assets | <u>84,403</u> |

Total current assets 17,332,080

PROPERTY AND EQUIPMENT — Net 418,334

TOTAL \$ 17,750,414

#### LIABILITIES AND NET ASSETS

##### CURRENT LIABILITIES:

|                                       |                  |
|---------------------------------------|------------------|
| Accounts payable and accrued expenses | \$ 136,980       |
| Accrued payroll and related benefits  | 442,623          |
| Medical claims payable                | <u>9,029,576</u> |

Total liabilities 9,609,179

##### COMMITMENTS AND CONTINGENCIES (Note 7)

NET ASSETS 8,141,235

TOTAL \$ 17,750,414

See notes to financial statements.

## SCAN LONG TERM CARE

### STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS FOR THE YEAR ENDED DECEMBER 31, 2007

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#### NET REVENUES:

|                                     |                |
|-------------------------------------|----------------|
| Premiums and reinsurance recoveries | \$43,010,001   |
| Supplemental premium                | 3,242,139      |
| Investment income                   | <u>611,229</u> |

|                    |                   |
|--------------------|-------------------|
| Total net revenues | <u>46,863,369</u> |
|--------------------|-------------------|

#### OPERATING EXPENSES:

|                                                 |                |
|-------------------------------------------------|----------------|
| Hospital, physicians, and other services        | 36,913,451     |
| Medical administration expenses                 | 1,660,794      |
| Marketing, general, and administrative expenses | 7,029,593      |
| Depreciation and amortization                   | <u>239,048</u> |

|                          |                   |
|--------------------------|-------------------|
| Total operating expenses | <u>45,842,886</u> |
|--------------------------|-------------------|

|                        |           |
|------------------------|-----------|
| INCREASE IN NET ASSETS | 1,020,483 |
|------------------------|-----------|

|                                |                  |
|--------------------------------|------------------|
| NET ASSETS — Beginning of year | <u>7,120,752</u> |
|--------------------------------|------------------|

|                          |                     |
|--------------------------|---------------------|
| NET ASSETS — End of year | <u>\$ 8,141,235</u> |
|--------------------------|---------------------|

See notes to financial statements.

## SCAN LONG TERM CARE

### STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2007

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#### CASH FLOWS FROM OPERATING ACTIVITIES:

|                                                                                               |                  |
|-----------------------------------------------------------------------------------------------|------------------|
| Increase in net assets                                                                        | \$ 1,020,483     |
| Adjustments to reconcile increase in net assets to net cash provided by operating activities: |                  |
| Depreciation and amortization                                                                 | 239,048          |
| Loss on disposal of property and equipment                                                    | 366,969          |
| Changes in operating assets and liabilities:                                                  |                  |
| Premiums and other receivables — net                                                          | (788,496)        |
| Prepaid expenses and other current assets                                                     | (84,403)         |
| Accounts payable and accrued expenses                                                         | (797,166)        |
| Accrued payroll and related benefits                                                          | 353,619          |
| Medical claims payable                                                                        | <u>6,930,255</u> |

|                                           |                  |
|-------------------------------------------|------------------|
| Net cash provided by operating activities | <u>7,240,309</u> |
|-------------------------------------------|------------------|

|                                       |           |
|---------------------------------------|-----------|
| INCREASE IN CASH AND CASH EQUIVALENTS | 7,240,309 |
|---------------------------------------|-----------|

|                                               |                  |
|-----------------------------------------------|------------------|
| CASH AND CASH EQUIVALENTS — Beginning of year | <u>9,133,371</u> |
|-----------------------------------------------|------------------|

|                                         |                     |
|-----------------------------------------|---------------------|
| CASH AND CASH EQUIVALENTS — End of year | <u>\$16,373,680</u> |
|-----------------------------------------|---------------------|

See notes to financial statements.

# **SCAN LONG TERM CARE**

## **NOTES TO FINANCIAL STATEMENTS**

**AS OF AND FOR THE YEAR ENDED DECEMBER 31, 2007**

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### **1. ORGANIZATION**

SCAN Group has been the sole corporate member of SCAN Health Plan Arizona since SCAN Health Plan Arizona's conversion to become an Arizona nonprofit corporation on April 6, 2006. SCAN Health Plan Arizona is licensed with the Arizona Department of Insurance and commenced operations in January 2007. SCAN Health Plan Arizona's application to the Internal Revenue Service (the "IRS") for recognition as tax-exempt, described in Internal Revenue Code (IRC) Section 501(c)(4), is pending. SCAN Long Term Care (the "Company") is an Arizona nonprofit corporation that filed, in March 2007, for recognition by the IRS as exempt from federal income taxes in accordance with IRC Section 501(c)(4) and was approved April 24, 2008. SCAN Health Plan Arizona is the sole corporate member of the Company; the Company is located in Phoenix, AZ.

Pursuant to the Amended and Restated Articles of Incorporation of SCAN Health Plan, filed with the California Secretary of State on September 4, 2007, and the Amended and Restated Articles of Incorporation of SCAN Group (formally known as Senior Care Action Network Foundation), filed on August 24, 2007, SCAN Group became the sole corporate member of SCAN Health Plan. Prior to such filings, SCAN Health Plan was the sole corporate member of SCAN Group.

On May 1, 2006, the Arizona Health Care Cost Containment System Administration (AHCCCSA) entered into a contractual agreement with the Company to participate in the Arizona Long Term Care System (ALTCS) program. ALTCS is the state of Arizona Medicaid program that administers acute care, long-term care, behavioral health, and case management services to frail seniors and the physically disabled. The enrollment of participants in the Company's managed care plan initially began on October 1, 2006; the contract was renewed for the new contract year started October 1, 2007, and is limited to residents of Maricopa County in the state of Arizona.

### **2. REGULATORY REQUIREMENTS AND OPERATIONS**

The Company is subject to regulatory oversight by AHCCCSA and is required to periodically file financial statements with AHCCCSA in accordance with various statutory accounting and reporting practices. At December 31, 2007, The Company's minimum capitalization requirement is \$4,500,000 as compared to actual capitalization of \$8,141,235.

In addition to the minimum capitalization requirements, the Company is required to establish and maintain a performance bond of standard commercial scope issued by a surety company doing business in the state of Arizona, an irrevocable letter of credit, or a cash deposit to AHCCCSA for as long as the Company has AHCCCS-related liabilities of \$50,000 or more outstanding, or 15 months following the termination date of this contract, whichever is later, to guarantee: (1) payment of the Company's obligations to providers and (2) performance by the Company of its obligations under this contract. As of December 31, 2007, SCAN Group maintains a letter of credit with Mellon First Business Bank in the amount of \$2,747,000 on behalf of the Company.

As of December 31, 2007, the Company is in compliance with the financial viability standards and performance guidelines as required by the AHCCCSA contract except for the requirement regarding total administrative cost percentage. For the year ending December 31, 2007, the administrative cost percentage is 15% as compared to the performance guideline of not more than 8%.

### 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation** — The accompanying financial statements include the accounts of the Company and have been prepared in accordance with accounting principles generally accepted in the United States of America ("generally accepted accounting principles"), including Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. FASB No. 117 establishes standardized external financial reporting by not-for-profit organizations.

Generally accepted accounting principles require not-for-profit organizations to report information regarding their financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets based on the existence or absence of donor imposed restrictions. As of December 31, 2007, the Company had no temporarily or permanently restricted net assets or contributions.

**Use of Estimates** — Management uses estimates and assumptions in preparing the financial statements in accordance with generally accepted accounting principles. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses. Actual results could vary from the estimates that were assumed in preparing the accompanying financial statements.

**Cash and Cash Equivalents** — Cash and cash equivalents primarily include highly liquid debt instruments purchased with a maturity of three months or less, as well as cash on hand and on-demand bank deposits.

**Premiums and Other Receivables** — Premium receivables include the capitation and reinsurance receivable due from AHCCCSA. Other receivables include amounts due from members, claim receivable or due from providers, and pharmacy rebates receivable. The Company establishes an allowance for those accounts that are estimated to have credit risk. Management does not believe that there is significant credit risks associated with reimbursement from AHCCCSA.

**Property and Equipment** — Costs associated with the development of internal-use software especially for the ALTCS program are capitalized in accordance with Statement of Accounting Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Amortization is provided on the straight-line method over 3 years.

Property and equipment are recorded at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, ranging from the lesser of 3 to 12 years or the remaining life of the lease for leasehold improvements and 3 to 10 years for furniture, fixtures, and equipment.

**Impairment of Long-Lived Assets** — Management reviews long-lived assets to be held and used in the Company's operations for impairment at least annually, or more frequently if circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets are deemed to be impaired if estimated undiscounted future cash flows are less than the carrying amount of the assets. Estimates of expected future cash flows are based on management's best estimates of anticipated operating results over the remaining useful lives of the assets. The Company measures the impairment as the amount by which the carrying amount of the asset exceeds the fair value of the asset. Management does not believe any impairment of its long-lived assets existed at December 31, 2007.

**Revenue Recognition** — Under the contracts with AHCCCSA, revenue is recognized based on the number of eligible members per month multiplied by the contracted monthly rate. Revenue is recorded in the month in which eligible members are entitled to health care services.

The Company is also paid monthly for all prior period coverage (PPC) member months, including partial member months by AHCCCSA. PPC revenue is recorded as premiums revenue in the month in which eligible members are entitled to health care services in the accompanying statement of activities and changes in net assets.

Certain estimates are required to record revenues and accounts receivable at net realizable value due to the nature of the membership contracts, specifically eligibility changes in the membership base. These estimates are based on actual historical adjustments to monthly capitation premiums. Inherent in these estimates is the risk that they will have to be adjusted as additional information becomes available. Such adjustments are typically identified and recorded at the point of cash application or account review.

**Reinsurance** — Reinsurance is a stop-loss program provided by AHCCCSA for the partial reimbursement of covered medical services incurred for a member beyond an annual deductible, the deductible is the responsibility of the Company. Reinsurance recoveries of \$1,151,055 for the year ended December 31, 2007, are included in premiums and reinsurance recoveries in the accompanying statement of activities and changes in net assets.

**Supplemental Premiums** — In accordance with the contract with AHCCCSA, \$3,242,139 of supplemental premiums were received from AHCCCSA based on membership levels and administrative expenses and recorded as supplemental premiums in the accompanying financial statements.

**Hospital, Physicians, and Other Services** — Health care costs are recorded in the period when members are entitled to services. Most physician and hospital services are provided under fee for service contracts. The accrued hospital costs for the fee-for-service contracts are recorded monthly based upon historical experience and expected trends in claim frequency and severity using accepted actuarial methods. These accruals represent claims reported, as well as estimates for claims incurred but not reported, and are included in medical claims payable in the accompanying statement of financial position. While the ultimate amount of claims and expenses is dependent on future developments, the management believes the liability for medical claims payable and the medical expenses included in the financial statements are reasonable estimates.

**Medical Administration Expenses** — Medical administration expenses include salaries, benefits, travel, and training expenses for the case managers and case management supervisors.

**Marketing, General, and Administrative Expenses** — Administrative expenses include salaries, benefits, premium tax, marketing, other general administrative expenses and an allocation from SCAN Health Plan Arizona.



**Income Taxes** — The Company is a nonprofit Arizona corporation and applied for a tax-exemption under IRC Section 501(c)(4). The Company received approval for their tax-exempt status during April 2008. The Company is in compliance with the provisions of IRC Section 501(c)(4) and is exempt from federal tax under IRC Section 501(a).

**Fair Value of Financial Instruments** — The carrying amounts of cash and cash equivalents, premiums and other receivables, and accounts payable, medical claims payable, and accrued expenses at December 31, 2007, approximate fair value because of the relatively short period of time between origination of the instruments and their expected liquidation.

**Recent Accounting Pronouncements** — In 2006, the FASB issued FASB No. 157, *Fair Value Measurement*. FASB No. 157 provides guidance for using fair value to measure assets and liabilities. The standard expands required disclosures about the extent to which entities measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. FASB No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. FASB No. 157 does not expand the use of fair value in any new circumstances. FASB No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of FASB No. 157 to have a material impact on its financial position or results of operations.

In February 2007, the FASB issued FASB No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115*. FASB No. 159 allows companies to elect fair value accounting for many financial instruments and other items that currently are not required to be accounted as such, allows different applications for electing the option for a single item or groups of items, and requires disclosures to facilitate comparisons of similar assets and liabilities that are accounted for differently in relation to the fair value option. FASB No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact that the adoption of FASB Statement No. 159 will have on the Company's financial position, results of operations, and cash flows but currently does not believe it will have a material impact on the Company's financial statements.

In July 2006, the FASB issued Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109*. FIN No. 48 increases the relevancy and comparability of financial reporting by clarifying the way companies account for uncertainty in measuring income taxes. FIN No. 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN No. 48 only allows a favorable tax position to be included in the calculation of tax liabilities and expenses if a company concludes that it is more likely than not that its adopted tax position will prevail if challenged by tax authorities. FIN No. 48 also provides guidance on the accounting for and recording of interest and penalties on uncertain tax positions. FIN No. 48 is effective for fiscal years beginning after December 15, 2007. Management is currently evaluating the impact that the adoption of FIN No. 48 will have on the Company's financial position, results of operations, and cash flows but currently does not believe it will have a material impact on the Company's financial position and results.

#### 4. PREMIUMS AND OTHER RECEIVABLES

Receivables as of December 31, 2007, consist of the following:

|                                      |                   |
|--------------------------------------|-------------------|
| Premiums receivable from AHCCCSA     | \$ 14,022         |
| Reinsurance receivable from AHCCCSA  | 828,397           |
| Supplemental premium receivable      | <u>3,831</u>      |
|                                      | 846,250           |
| Less allowance for doubtful accounts | <u>(383)</u>      |
| Premiums receivable — net            | <u>845,867</u>    |
| Pharmacy rebates                     | 7,674             |
| Overpayment to providers             | <u>20,456</u>     |
| Other receivables — net              | <u>28,130</u>     |
| Total                                | <u>\$ 873,997</u> |

#### 5. PROPERTY AND EQUIPMENT

Property and equipment as of December 31, 2007, consist of the following:

|                               |                   |
|-------------------------------|-------------------|
| Computer software             | \$ 717,141        |
| Less accumulated depreciation | <u>(298,807)</u>  |
| Total                         | <u>\$ 418,334</u> |

#### 6. MEDICAL CLAIMS PAYABLE

Activity in medical claims payable as of December 31, 2007, is as follows:

|                      |                     |
|----------------------|---------------------|
| Beginning balance    | <u>\$ 2,099,322</u> |
| Incurred related to: |                     |
| Current period       | 37,630,328          |
| Prior periods        | <u>(649,221)</u>    |
|                      | <u>36,981,107</u>   |
| Paid related to:     |                     |
| Current period       | (28,611,734)        |
| Prior periods        | <u>(1,439,119)</u>  |
|                      | <u>(30,050,853)</u> |
| Total                | <u>\$ 9,029,576</u> |

As payments made in the current year related to prior years' estimated claims, the provision for medical claims payable, and claim adjustment expense decreased by \$649,221 for the year ended December 31, 2006, due to a lower-than-anticipated settlement of claims.

Liabilities for unpaid claims and claim expenses are estimates of payments to be made under health coverage for reported but unpaid claims and for incurred but not yet reported claims. Management develops these estimates using actuarial methods based upon historical data for payment patterns, cost trends, product mix, seasonality, utilization of health care services, and other relevant factors.

## 7. COMMITMENTS AND CONTINGENCIES

**Credit Concentration** — The majority of operating revenues for the year ended December 31, 2007, results from contracts with the AHCCCSA. AHCCCSA cancellation of its contract with the Company or nonpayment of amounts due to the Company would have a material adverse effect on the Company's financial position and operations.

**Medical Claims Risk** — The Company is exposed to certain medical claims risk due to the nature of its operations. The major portion of medical services provided for the Company's members is performed under contract. However, the Company regularly incurs costs for noncontracted services from providers. In addition, in the event of default or financial difficulties with certain providers, the Company could be liable for outstanding claims, which, if substantial, could have a material adverse effect on the Company's financial position or results of operations.

**Cost Containment Measures** — Both government and private pay sources have instituted cost containment measures designed to limit payments made to providers of health care services, and there can be no assurance that future measures designed to limit payments made to providers will not adversely effect the Company's financial position.

**Professional Liability Insurance** — The Company carries professional liability insurance with coverage of \$5,000,000 per occurrence and in aggregate in any one year. In the ordinary course of business, the Company is subject to the claims of its members arising out of decisions to restrict treatment or to restrict reimbursement for certain services.

**Litigation** — The Company is involved in various legal actions arising in the normal course of business. After taking into consideration legal counsel's evaluation of such legal actions, management believes the outcome of these matters will not have a material adverse effect on the Company's financial position.

## 8. TRANSACTIONS WITH SCAN HEALTH PLAN ARIZONA

SCAN Health Plan provides administrative services in support of the operations of the Company and SCAN Health Plan Arizona. The Company and SCAN Health Plan Arizona have agreed to reimburse SCAN Health Plan for providing and arranging the legal, accounting and financial, information technology and other services. The amount of the expenses to be reimbursed to SCAN Health Plan is allocated to the Company based on time allocation by each department of SCAN Health Plan. The charges for these services to the Company totaled \$1,879,000 in 2007, and are included in administrative expenses in the accompanying financial statements.

As of December 31, 2007, the \$13,000 due from SCAN Health Plan and \$31,000 due from SCAN Health Plan Arizona are included in prepaid expenses and other current assets in the accompanying statement of financial position and represent costs incurred in the ordinary course of business by, or on behalf of, the Company. The amounts were settled through intercompany settlement within 30 days.

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